RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Nov. 30, 1988 **LETTER 1005**

Nov. 18 DJIA 2062.41; PTI 2794; A-D Ratio -12.80
Nov. 25 DJIA 2074.68; PTI 2799; A-D Ratio -12.89
Current Dow Yield: 3.80%; Dow P/E: 12.3
Dow 200-day MA: 2072; DowPow: 586
Percentage of undervalued blue-chips: 21%

THE PICTURE: The ultimate fantasy -- George Bush calls a press conference and announces, "See, I told you back in 1980 that we were in for eight years of Voodoo economics." Nah, that could never happen. But is pressure for truth-in-government finally emerging? Peter Peterson in a November 17 op-ed piece in the *WSJ* writes that "George Bush should institute a revolutionary principle: truth in budgeting." In other words, stop all the nonsense and deception on the budget and tell the American people the real, unvarnished truth.

On the same day (Nov. 17) Fed chief Alan Greenspan announced to the world that deficits definitely do count, and that "the deficit has already begun to eat away at the foundations of our economic strength." Furthermore, Greenspan stated we are not going to grow out of our deficits. Finally, Greenspan warned that if something isn't done soon about the deficits the Fed is going to tighten the money screws.

We can read Mr. Bush's lips, but we can't read his mind. Will he get down to business? Will he come out with a real, honest-to-God plan to cut the deficit? Will he do a flip-flop and ask to raise taxes? Will Bush have the strength and courage to lay it on the line to Congress and the American people? Or will the markets have to provide the real pressure, as they did on October 19,1987?

Time will tell, but one way or another there will be no avoiding the pain. That's what the bear market is about -- taking the pain. So far, Wall Street alone has taken most of the pain. Over the past year 17,000 people in the securities industry have lost their jobs. As one observer put it, "If you think you had trouble getting hold of your broker during the '87 crash, wait 'til you see what happens next time there's trouble."

The truth is that this nation is in the grip of a major primary bear market, and bear markets exist for the purpose of correcting excesses. The excesses that Americans have lived with over the past 30 years are so ingrained that many otherwise intelligent people actually deny that they even exist. Thus we are told that "the deficits aren't large compared with GNP," we are told that "5% inflation is something we can live with," we are told that "we can grow out of our deficit problems," we are told that "good old Yankee toughness and ingenuity will see us through, just as it has done so often in the past."

The bear couldn't care less for all the excuses and "soft landing" fantasies. Count on it --there will be pain, that's what bear markets do, they correct through pain. Unless, of course, you believe that the loss of thousands of jobs and billions of dollars in assets won't be a painful process.

Ultimately, the pain of getting off the deficit wagon will have to surface in one or more of the following areas: (1) job losses, (2) lower security prices, (3) declining home prices, (4) more inflation, (5) higher taxes, (6) declining government services, (7) lower living standards.

I feel that there are two great illusions that the American people now have to deal with. The first is that we can have real prosperity while borrowing $3 billion a week (which is the cost of the current deficit). I'm not going to go into all the reasons why I believe this is an illusion. I'll just say, study the compound interest tables. If you think a nation can continue running up deficits and piling up interest costs on those deficits at compounding rates, well, there's nothing more I can tell you.

The second great illusion is that "this primary bear market isn't going to its ultimate conclusion, no, it's simply a mess on Wall Street that can be halted if the right buttons are pushed." Thus, I hear on TV or radio each day that "if the October trade deficit comes in lower" or "if the Japanese would just cooperate with us on trade restrictions" or if "the Fed would just ease up a notch" everything would be fine, and the market could start climbing just as if the bull market top and subsequent crash of 1987 never happened.

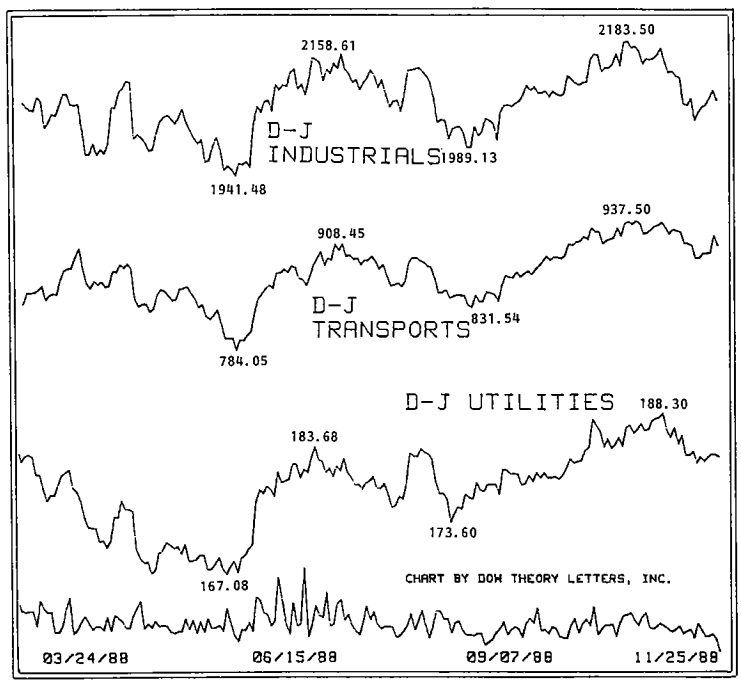
By the same token TV commentators and newspaper writers see fit to explain every move of the market in terms of current events. Seldom, if ever, is the concept of a tidal decline mentioned. If we listened to all the media talk we'd believe that there is no such thing as a primary trend, and that the market simply bounces up or down each day to the tune of the prevailing news.

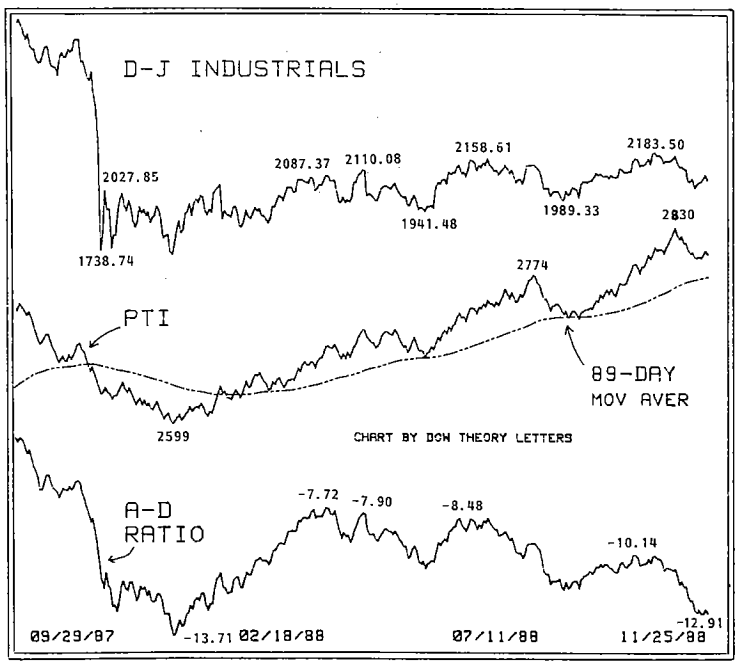
All right, all the above is simply background. Now I'm going to deal with the real market itself. And please study the following items carefully.

I said from the beginning that this bear market was NOT GOING TO BE EASY, and I want to repeat that thought now -- in spades.

(1) The advance-decline ratio topped out last March 17. It has been declining steadily for almost 10 months. That's a long time for market breadth to decline without a respite.

(2) My Primary Trend Index (PTI) has refused (so far) to confirm the action of the A-D ratio on the downside. As you can see on the

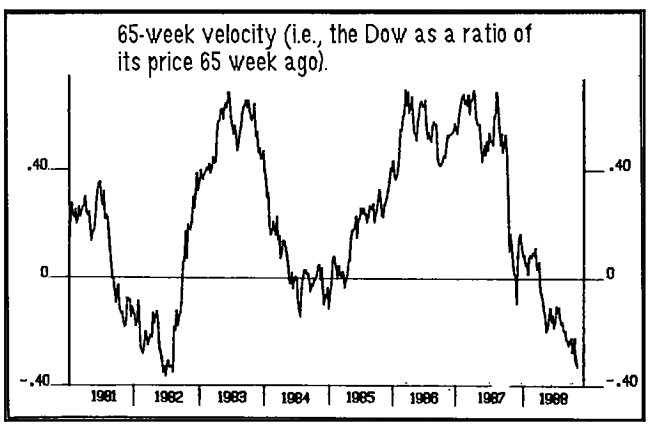




page 2 chart, the PTI is still (amazingly) holding above its 89-day moving average.

(3) The major stock averages have NOT (so far) confirmed the weakness in the A-D ratio. In order to confirm, the Averages would have to break first below their August and then below their April lows. The August lows for D-J Industrials and Transports were 1989.33 and 831.54 respectively. The April lows for Industrials and Transports were 1941.48 and 784.05 respectively.

(4) The 65-week velocity index (i.e., the Dow as a ratio of its price 65 weeks ago) is now down to the sold-out level it last hit in 1982 (see chart, which is courtesy of my good friends, the Aden sisters).



(5) Judging from some of other indices I follow (i.e., Lowry's buying power/selling pressure, McClellan index, stochastics), the market is now moving toward a substantial over-sold condition.

(6) Sentiment on Wall Street is now fairly negative. Everybody's complaining, brokers are quitting or being fired, the public is not making any money. Not too many people are thinking in terms of a decent recovery rally (but be careful, because in bear markets sentiment tends to stay pessimistic, deepening as the bear market deepens).

(7) No question about it, there is a lot of money piling up on the sidelines in money market funds, CDs, T-bills and what have you.

What's all this telling me? It's telling me that we are moving ever-closer to a decent secondary bottom. Now admittedly, in order to hit a bottom, it may take a bit more selling, it may even require a final downside wipe-out (a wipe–out would be perfect for establishing a good bottom). Actually, I would guess that somewhere between now and the end of this year the market could establish a good bottom.

Question: Should we try to trade off the bottom? Unfortunately, I can't answer that question. I can't answer it because I can't analyze the psyche of each and every one of my subscribers. Also, the next rally (and I don't care how good it looks) will not represent the beginning of a new bull market.

All right, why am I still so cautious? And why do I think we're still in the early stages of a major primary bear market?

(1) The yield on the Dow is still below 4%. No bull market in history ever started from such an overvalued area.

(2) The percentage of undervalued blue-chip stocks on the NYSE is now only 21%. Bull markets start when this percentage has risen to 77% to 82%. We're not remotely close to those figures yet.

(3) The 1974-87 bull market lasted 13 years. The bear market has been in force for only 15 months. That's not enough time to correct a 13-year bull market. Three or four years would be more like it.

(4) At this time the T-bill/stock yield ratio is totally out-of-whack (see last Letter). Bull markets (and most advances) don't begin with T-bills yielding more than twice what blue-chip stocks yield.

(5) The bill rate is now almost 1.5% above the discount rate, and this puts pressure on the Fed to raise the discount rate again. Another boost in the discount rate would be a third boost, and three boosts have always amounted to a death blow for the stock market (the "three steps and stumble" rule).

(6) There are three financial manias operating simultaneously in the world today: (a) the US LBO, buy-out mania; (b) the US deficit and debt mania, and (c) the Japanese stock market mania. And believe me, all three of these are full-fledged manias! Now one financial mania is dangerous enough, but three are far too many.

(7) The cycle picture is wrong. The four–year cycle (please study the cycle piece in this Letter) should be heading down about now, putting cyclical pressure on stocks until 1990.

(8) Historically, the year after a presidential election is a down-year or at least a rough one.

Conclusion: This bear market (Lord help us) could turn out to be as difficult as the 1966-74 period (but hopefully, not as long). During the '66 to '74 span we experienced a number of huge trading range swings with the final bear market wipe–out not appearing until 1973-74.

As I see it, we have two choices in dealing with this bear market: (a) We can elect to buy the rallies and try to trade out of those rallies at the tops. Or (b) we can be conservative and stay out of the whole thing until we get a true, great-value, bear market bottom (and we will get one eventually, but waiting for it will require the patience of 10 people.

Of course, today we can purchase futures on the various stock indices plus options on the futures (we didn't have these during '66 to '74). And you may elect to trade the market that way. But lest you forget, you can lose money on futures and options. When you play that game you are also playing against time. And it's also well to remember that if you get whip-sawed on three or four futures trades you can find yourself out a bundle. Finally, the option or futures game is a very expensive one -- options are almost never cheap.

At any rate, I did want to point to some of the possibilities in the period ahead. Let me put it this way -- this market is gradually moving toward "oversold." It's getting closer and closer to the point where a decent bottom and then a good advance "should" be

in order. But overall, it's still a murky picture, the monetary situation is anything but appetizing, and I continue to suggest conservatism. Remember, in a bear market the winner is the one who loses the least. You can lose a lot of money "playing around" and trying to "beat the bear." I know. I've tried it -- many times.

INVESTMENT POSITION: People have short memories, and people get greedy. They forget that during the 1950s Treasury long bond yields averaged around 3%, while during the 1960s the long governments had an average yield of 4.5%. When the long-bond finally hit 5% in the late-1960s (the famous "magic fives") it was said that "5% government interest will draw money from the moon."

Today, two-year government notes will pay you better than 8%, while investment-grade municipal bonds (tax-free) will pay you over 7%. Meanwhile, T-bills provide yields of over 8%, free of state taxes. These yields are double or better the yield on the D-J Average.

Question: With guaranteed fixed-income instruments so attractive compared to stocks, should one show even speculative interest in stocks? I can't answer for everyone, but my answer for myself is "no."

For traders, let me put it this way. If I were going to play for a rally stemming from a sold-out market, I'd probably switch into a no-load equity fund. Or I'd buy a collection of the Dow stocks which are still bullish. On a cold, technical analysis I count the following Dow stocks as still bullish in that they are all above their own 30-week moving averages and all are showing positive relative strength: Amer. Tel., Boeing, GM, Merck (Merck is on the edge). Unbelievable -- only four Dow Industrial stocks bullish, that's all I count.

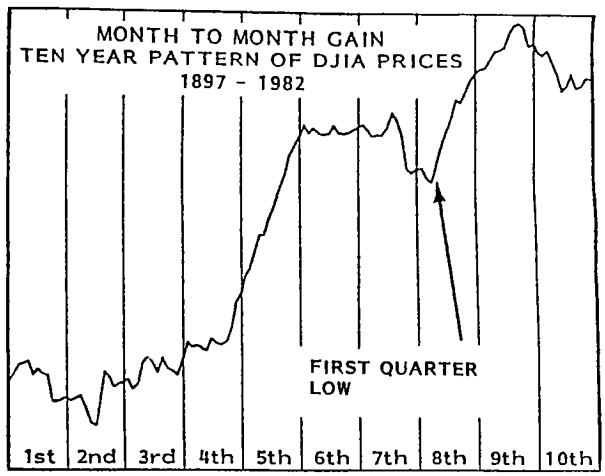
After a huge run-up, the bonds are now correcting as I indicated they might. Meanwhile, short-term rates are pushing up to within shooting distance of the long rates. This means a flattening of the yield curve, but it also means very attractive T-bill yields -- well over 8%. If the short rates go over the long rates we will have an inverse yield curve -- always a sell signal for stocks.

CYCLES: I continue to receive letters from market students asking about cycles. I've written many pieces on cycles, and my conclusions are always the same -- I just don't know whether cycles work or not. Sometimes they seem to work, sometimes they don't. I've always felt that about the time you're depending on a cycle top or bottom to appear, somehow it fails to materialize. But it may be that when a cycle top or bottom fails to appear, this omission tells us as much about the market as when a top or bottom does appear as expected.

I don't know whether the "decennial pattern" can properly be called a cycle. The decennial pattern is based on the thesis that years ending in the same digit (for instance, 1927, 1937, 1947, 1957, 1967, etc.) tend to follow the same pattern. In fact, *Growth Fund Guide* (Box 6600, Rapid City, SD 57709) put out a decennial chart showing the typical action in each year based on the market action of the past 80 years.

Note on the chart that after a low in the first quarter of a year ending in 8, the market "should" rise throughout the 8th year and continuing rising into the third quarter of the 9th year. Applied to the present, this means that following a low in the first quarter of 1988 the market "should have risen" for the rest of 1988 and into the third quarter of 1989.

But what actually happened? What happened was that the advance-decline ratio (which tracks the direction of the majority of stocks on the NYSE) topped out on March 17, 1988 and has been heading lower ever since. Thus, the action in 1988 has been



counter-cyclical or against the normal expectations of the decennial pattern. But perhaps the decennial strength rubbed off to some extent on the Dow, since the Dow stocks have acted considerably better than the average stock on the NYSE.

My point is this: According to the decennial pattern, 1988 should have been a very strong year. The fact that it hasn't been may be telling us that another force is much stronger than the decennial pattern. What is this other force? The force of the primary bear market.

Looking at the chart, it could be that the decennial power will help this market until the third quarter of 1989. After that, the power of both the bear market and the decennial pattern will be strongly negative.

Here's another study which I think is well worth looking over. This is a true cycle study since it deals with periodicity. Bill Bretz *(Juncture Recognition,* Box 1209, Pompano Beach, FL 33061) writes about the well-known four-year cycle. He notes that following each four-year cycle low, the cycle turns up and there is a cycle peak which arrives approximately 75 months later.

Bretz notes that going back to 1932 there have been wide variations in this cycle. But let's examine the four-year cycle lows in terms of recent history. Here's the evidence:

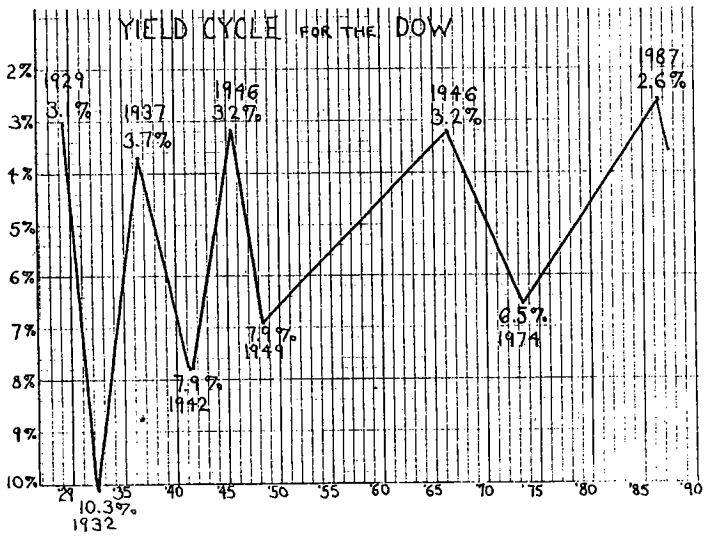
SPAN BETWEEN A 4-YR LOW AND AN IMPORTANT PEAK
From June 1962 (535.76) to Dec. 1968 (985.21) = 78 months
From Oct. 1966 (744.32) to Jan. 1973 (1051.70) = 75 months
From May 1970 (631.16) to Sept. 1976 (1014.79) = 76 months
From Dec. 1974 (577.60) to April 1981 (1024.05) = 76 months
From Feb. 1978 (742.12) to Jan. 1984 (1286.64) = 71 months
Average span = 75 months

The last major cycle low occurred in August **1982** at Dow 776.92. Adding 75 months (the average span) to the 1982 low takes us to November 1988. In other words, we are there now. November represents the cycle peak for the 75-month cycle which began in 1982. So on the basis of this study, the market is about at the cycle peak and ready to go down (or already going down).

Finally, I am going to present a study that I follow carefully and one that I've written about repeatedly. This is what I term "the Dow yield cycle." The yield cycle is not a strict cycle since true cycles deal with periodicity and the Dow yield cycle does not. The yield cycle is really a swing -- a swing which goes from high yields on the Dow to very low yields on the Dow.

On the accompanying chart I have traced the history of extreme high and low Dow yields going back to 1929. As the song goes, "it's still the same old story," and the story on Wall Street is of swings in the Dow to high yields of 6% or better (at major bear market bottoms) and then swings in the Dow to low yields of around 3.5% or less (at major bull market tops).

It is important to understand that yields alone will not identify a bull market top or a bear market bottom. But Dow yields represent one



of the important criteria I use in identifying a top or a bottom. For instance, to identify a major bull market top I would want to see evidence of excited speculation, high volume, wild rumors, major upside moves in low-priced stocks, predictions of even higher prices, and along with all these a condition of overvaluation as confirmed by low Dow yields.

Referring to the chart, we see that the Dow is still in the area of overvaluation with the Dow yielding only 3.8%. Thus, it is obvious that the next bear market bottom is still far away.

NOTES & QUOTES: Help! I'm being flooded with letters from subscribers. Many of the letters include excellent material which I often use in these reports. I appreciate receiving these, and I thank you for them. But other letters ask many questions, usually questions about personal investment problems. I really am very sorry, but I don't have the time or the energy to answer all the questions from subscribers regarding their own investment problems or decisions. Furthermore, a few years ago I de-registered with the SEC. Therefore, legally I am not allowed to give personal investment advice.

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Here's what the Nov. 19 London *Economist* said about the dollar: "Since its peak in February 1985 the trade-weighted dollar has fallen by 40%. A dollar now buys much more in shops in America than a dollar's worth of yen buys in Japan or a dollar's worth of D-marks buys in West Germany. This is the best test of a currency's competitiveness, and it suggests that the dollar is already undervalued." Russell comment: If the dollar's a bargain, how is it that our trade-balance doesn't turn around, and how it that foreigners aren't bidding up the dollar? Easy, Americans are still buying far too many imports and are not exporting enough. Our creditors know that if this trend continues, there will be a dollar crisis. And who wants to hold a crisis currency? Do you know anyone who is hoarding pesos?

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Whatever else people may say about Dick Nixon, nobody ever accused him of being stupid. About Dan Quayle: there's a lot of flack being thrown at Quayle (and I personally think much of it is unfair). After a 90-minute interview, here's what Nixon recently said of Quayle: "This is the first time I had a chance to talk with Senator Quayle. I was very surprised. He is a very different man from the intellectual midget who has been portrayed in the media. This is a man who has strong views. He's highly intelligent. He's highly dedicated. I think he's going to be an excellent vice president."

* *

Investors may have halted their buying of stocks, but the money hasn't stopped in one area, and that's the area of art. In the sale of the paintings of William and Edith Goetz at Christie's a few weeks ago, 28 art objects went for an astounding total of $87 million -- and the sale lasted less than an hour. It was a record sale for a single owner.

* *

I don't think Americans comprehend the excitement and ferment that is going on in Asia. It's as if Asia is exploding into the 20th century but with one big advantage -- Asians today possess the work ethic Americans had in the 19th century.

Note this from the *Wall Street Journal* special technology report (Nov. 14): "In the beginning the Japanese made things cheaper, but we derided the stuff as junk. Later, in the 1960s and '70s the Japanese started to make things cheaper and better and we began to worry, with good reason. Japanese cameras, calculators and cars weren't junk, and they were competition. All the while, though, we had one big consolation. The Japanese were essentially copycats. Still we had our creativity, our new ideas, our Nobel Prizes. With these, we could keep climbing to higher and higher levels of technology and stay ahead. This would be our ultimate refuge, our enduring competitive weapon. No longer. Today Japan is challenging us even here, on the slippery rockface of new ideas, innovations, new technologies. Japan is struggling to pass the US in new ones. It is struggling mightily to be first."

And from a businessman-subscriber who is a partner in a S. Korean company I received an eye-opening package containing copies of the daily *Korean Times* (in English), the daily *Korea Herald* (in English), the *Korean Economic Journal* (monthly in English), *Korea Business World* (monthly in English), and *Business Korea* (monthly in English). If you don't think business is aggressive and booming in Korea, you don't know what's going on. A lead article in the *Herald* states, "Kremlin Sets Sights on Share of Asia's New-Found Wealth."

In a letter to me this genetleman describes a scene in Seoul: "Interestingly, while eating breakfast one can watch young men carry huge containers of hot soapy water out the door to scrub the sidewalks with brushes. All the cars in Seoul are new, and compared with the US spotlessly clean. I'll bet that a minimum of 10,000 cars in Seoul are chauffeur-driven. Simple reason, traffic is so tough the businessmen are afraid to drive. Three hundred more cars every day in Seoul. . . . Japanese fly in in great numbers daily to Seoul for low-priced partying and buying, spending money like a tidal wave. They buy high class art, porcelain, pottery, furniture, antiques. Four Japanese businessmen wanted the absolute finest night including dinner and sex. They spent US $20,000 for their one night. . . . Entire first floor of Lotte Department store in downtown Seoul is a delicatessen with all the delights of the world from European breads baking in front of you to real Swiss chocolate (not the variety sold to 'US taste'), to the world's best liquors. Designer clothes upstairs makes one realize what designer clothes really are. Printemps fashion store of Paris a couple of blocks away." Russell comment: the letter was a very long one, and these are just a few sample comments. As I see it, S. Korea could be Japan's next real competitor. Final comment: At the end of 1985 Korea's foreign debt hit an all-time high. By the first half of 1990, Korea will be a creditor nation. Korea's current account surplus is rising faster than even the optimists expected.

* *

The ocean south of San Diego is famous for fishing. This year veteran fishermen have caught the biggest blue-fin tunas they've ever seen, many weighing 350 to 600 pounds. What happens to these monsters? They are flown to Japan for sushi and sushimi. The current catch is now being auctioned off in Japan where it is bringing astounding prices of $16 to $24 a pound (total catch so far 83,880 pounds). The prize tuna is going to Tokyo's top restaurants where it is selling for $10 a bite or $125 a pound (the Japanese believe that eating rare old fish adds to an individual's strength and longevity).

* *

The cover of *US News & World Report* (Nov. 21) headlines the story, "How Bush Will Change the Reagan Revolution." I'm not sure people understand what the Reagan revolution was all about, but here are a few items worth noting (of course, Congress is equally responsible for the following).

Mr. Reagan ran his campaign on a cut-taxes, balance-the-budget, cut-government-expenses ticket. How did he do? Here are a few answers. Taxes: The government in 1980 under Carter took in 19.4% of total GNP in taxes. In 1988, after eight years under Reagan, the government takes the exact same amount in taxes -- 19.4% of GNP. Spending: According to the Congressional Budget Office, government spending in 1980 totaled $591 billion. In fiscal 1988 it reached $1 trillion, an increase of 80% in eight years. Interest on the national debt rose from $53 billion in 1980 to $151 billion in 1988, a rise of 185%. Defense spending grew from $134 billion in 1980 to $293 billion in 1980, a rise of 118%. Social Security and other mandatory programs rose from $278 billion in 1980 to $498 billion in 1988, a rise of 79%. Government spending today represents 22.3% of GNP while revenues to government are 19% of GNP. The difference is the deficit. It's all part of the Reagan revolution.

Here's a paradox -- government spending and receipts are about equal today. The killer is the interest on the national debt, which is compounding as we speak. The interest on the national debt this year will be $151 billion or $3 billion a week (next year it will rise to $163 billion). The interest on the debt in 1989 will be larger than this year's deficit. Anyone wonder how we can be in a bear market?

* *

International shocker: A KGB officer suggested at a recent top brass meeting in Moscow that the KGB meet with their CIA counterparts to promote detente by allowing officers for the two agencies to get to know each other and to review past operations of the two agencies in order to avoid future misunderstandings.

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Things To Come: At a Montreal meeting, Philip Benton Jr., president of Ford's Automotive Group, told businessmen that by 1990 worldwide auto production could outdistance demand by 9 million cars a year. "About 6 million of that excess will probably be aimed at North America," he said, adding that the "car-clogged market" will escalate to unheard-of levels as 40 manufacturers produce cars in 30 countries. He concluded, "Not everyone will be able to hang on. There will be plenty of casualties."

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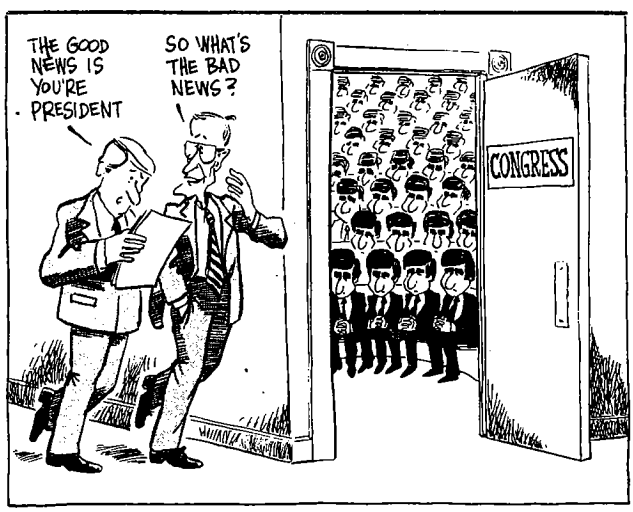
If one picture is worth a thousand words, this cartoon is worth maybe five thousand words. It's by Wasserman of the Boston Globe.



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What are the odds on winning a lottery in the various states? Here are some odds: Calif., 1 in 14 million; Ill. and NY, 1 in 12.9 million; Mass., 1 in 9.4 million; Mich. and Ohio, 1 in 7.1 million; Pa., 1 in 6.1 million; Conn., Me., NH, Vt., 1 in 3.8 million.

* *

My friend Jim Grant (*Grant's Interest Rate Observer*, 233 B'way, NYC 10279) notes that the great 1920-46 bull market in bonds ended in April 1946 with the yield on the 2-1/2% long government bond at 2.13% (that's right, 2.13%). Then came the great debt-binge-based bear market in bonds. By September 1981 the long Treasury bond hit a peak yield of 15.2% at which point the bear market ended.

* *

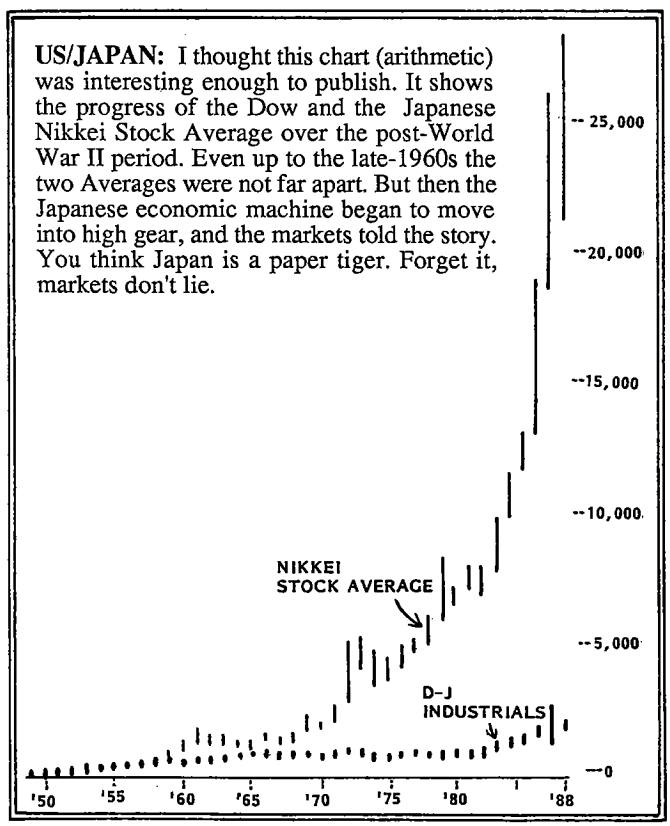
The Nov. 17 *LA Times* included a major article on the influence of the Eastern press. ABC, NBC, CBS, *Time, Newsweek, The NY Times, Wall Street Journal*, the wire services -- all are in the East and to these media people "the news" is basically what's happening in the Boston-NYC-Washington corridor. Thus, such major events as the drought, immigration, the tax revolt of the '70s received weak attention from the media, even though they affected the rest of the nation. The biggest "misses" by the Eastern media have been: (1) the massive rise in America's Hispanic population, which Newsweek's Houston Bureau chief calls "one of the most profound elements of change in our culture" and (2) the rise of Asian influence and power in the US (the Eastern press has always been tuned in to and conscious of Europe whereas they have been largely oblivious of the growing power and influence of the Asian nations).

Thus even now the press does not seem to comprehend the full meaning of the growing power (particularly economic power) and influence of Japan, China, South Korea, Hong Kong, Singapore, and Taiwan. I can tell you that we in the Western US see it. For instance, four of the 10 largest banks in California are owned by the Japanese. And on a more personal basis, last week a Japanese couple stopped by my house and very politely asked for directions to a few of the more affluent streets in our neighborhood. I doubt if they were just sightseeing.

* *

Tax the Other Guy: The Times Mirror Co. recently ran a poll to see what voters thought of 20 possible deficit-reducing measures. Interestingly, three that were voted for were tax hikes. What were the hikes? A hike in the cigarette tax, a hike in the liquor tax, and a hike in income taxes for people earning $80,000 or more.

US/JAPAN: I thought this chart (arithmetic) was interesting enough to publish. It shows the progress of the Dow and the Japanese Nikkei Stock Average over the post-World War II period. Even up to the late-1960s the two Averages were not far apart. But then the Japanese economic machine began to move into high gear, and the markets told the story. You think Japan is a paper tiger. Forget it, markets don't lie.



GOLD, INFLATION: These two charts are worth studying (prices are based on the weekly Friday closings). The top chart traces gold from January 1986 to the present. Gold has been traveling down a bearish channel since the end of 1987. The picture revealed by the channel is clear enough. If gold can hold above its 1988 low of 389, that will be a major plus. It will be even more of a plus for the

yellow metal if it can hold above the psychological 400 level. On the upside, a rise to, and then above, 440 would take gold out of the channel. Such action would obviously be bullish.

Gold is usually viewed as a barometer of inflation or deflation. This brings us to the lower graph, which traces the weekly action of the CRB Commodities Futures Index. The CRB has been moving up on a trend basis since mid-1986. The CRB hit a high last June, but since then it has been trending down. Last week the CRB broke slightly below its rising trendline, a move which certainly does NOT smack of inflation.

In today's gold picture, there is much more involved than inflation or deflation. There is the matter of the dollar. Most people are somehow not aware of it, but the dollar is defined in terms of gold (i.e., how many dollars it takes to buy an ounce of gold). As the dollar weakens, the dollar-price of gold tends to rise. True, sometimes there are major lags in the equation, but ultimately the price of gold in terms of dollars is reflected in the dollar-price of gold.

Since 1985 the dollar has dropped nearly 50% in terms of the major currencies so the question may be asked, "Why hasn't gold doubled in price?" My answer again is that there is often a lag in the dollar/gold ratio, and this is one of those times.

You must remember that gold pays no interest, so the gold-oriented investor is always (consciously or unconsciously) asking himself, "Am I better off buying money instruments and collecting the interest or am I better off buying gold and being protected against inflation or a financial crisis?"

The investor may reason as follows: "I can buy three-year Treasury notes at around an 8.80 yield. This mean I can collect around 20% (after taxes) from those notes between now and the end of 1991. Will the dollar drop 20% over the same period? If it doesn't, if the dollar holds steady or if it drops only 10% I'll be ahead buying notes over gold. And, of course, if by some miracle the dollar is higher three years from now, I'll be way ahead buying notes rather than gold."

So what does the intelligent investor do? He diversifies, putting most of his money into high-yielding money instruments while buying gold coins as a hedge.

Note: I can't remember when I've ever recommended that my subscribers buy silver. Years ago the time-honored gold to silver ratio was one ounce of gold would buy 15 ounces of silver. With silver near $6 an ounce, the ratio is now 69 (i.e., an ounce of gold will buy 69 ounces of silver). I've watched silver since the early 1950s. Don't ask my why, but I don't know any other item which has cost investors and speculators so much. They call silver "the poor man's gold." Maybe that's because if you speculate in silver long enough, you will end up a poor man.

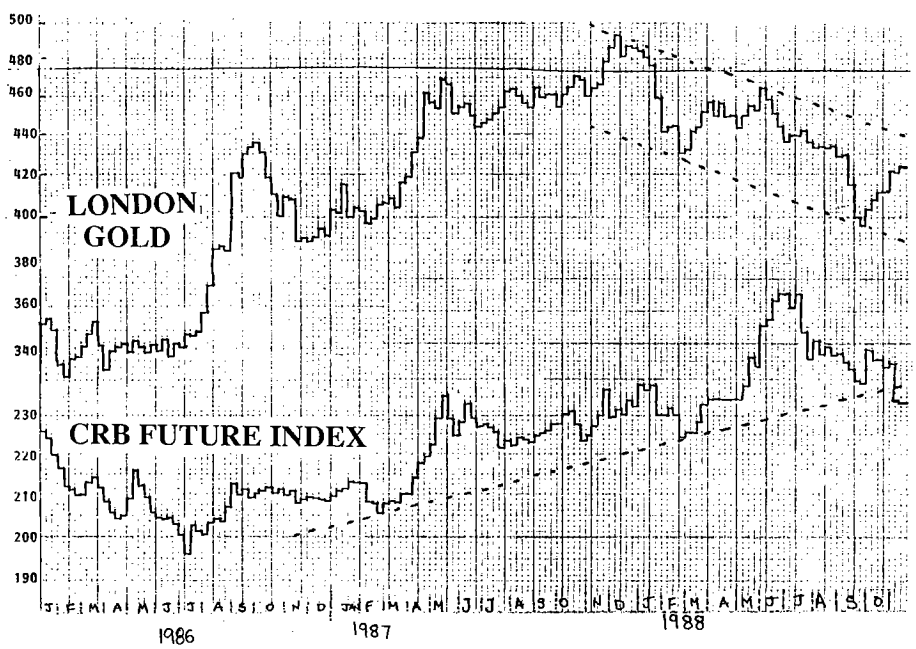
Meanwhile, despite massive intervention, the dollar has sunk to a 40-year low vs. the yen. Subscribers keep asking me how to hedge against the sliding buck. One "fun" way is with top-grade diamonds (remember, I recommended diamonds repeatedly a few years ago -- before their big rise). DeBeers, which controls 90% of the world's diamond production and sales, has been pegging the diamond price to the yen, which is why diamonds have risen so much in terms of the weak dollar. At any rate, don't sell your wife's jewelry -- those stones may be your best hedge against dollar weakness.

Another way to hedge against the dollar is via one of the cash funds. *International Cash Portfolios* (a listed mutual fund) allows you to switch your dollars into any of 12 different currencies. For information call 1-800-232-3310. Last week Shearson Lehman offered a cash fund which allows you to move into any of four different currencies. Call Shearson for info on this one as well.

LATE NOTES: The Fed is squeezing gingerly. Fed funds are well over 8%, and in turn the T-bill rate is currently 1.6% above the discount rate. It seems the Fed is (1) mildly worried about inflation, (2) more worried about the twin deficits, (3) and most worried about the weak dollar.

Normally, when the spread between the T-bill rate and the discount rate is this large, you can start looking for a boost in the discount rate. So the question on my mind is -- will the Fed get really tough and boost the discount rate for the third time? Fed Chief Greenspan is no fool. He's a market man, and he knows that such action (i.e., a third successive discount boost) would be murder for the stock market, since a third boost would set off the well-known "three steps and stumble" sell signal for stocks.

Two-year Treasury notes are now yielding 8.7% (free of state taxes). A safe 8.7% over two years, it's almost irresistible! Over any long period of time, a good money manager will do well to average 10% a year on his funds. Here's 8.7% guaranteed. In today's market, the value-minded investor has to be viewing stocks as expensive and speculative and money instruments as cheap.



Last week Britain (suffering a massive trade imbalance) lifted their bank rate to a whopping 13%. On Monday (Nov. 28) US banks boosted their prime to 10.5%. With rates rising in both the US and Britain, many observers are wondering whether this could be the beginning of an international rate war although it is obviously too early to tell. But any way you look at it, high-yielding short-term paper is providing vicious competition for stocks.

As for the stock market the span between the blue-chip stocks and the rest of the market grows ever wider. While the Dow resists on the downside, the rest of the market does not fare as well. The Amex and the Nasdaq stock averages have formed large head-and-shoulders tops and are breaking down (as is the A-D ratio on the NYSE). There's no question about it, the majority of stocks on all the exchanges are under distribution. If past history is any guide, the majority of stocks will ultimately set the trend for the entire market.

Through all today's confusion one thesis should be kept firmly in mind. This is a bear market. Ultimately, the bear will have his way.

NEXT MAILING: Dec. 14